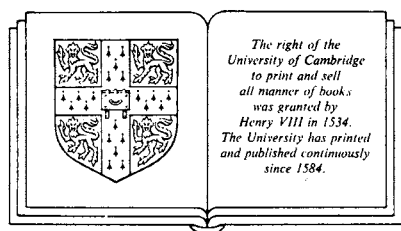


Capitalism, socialism, and serfdom

Essays by

Evsey D. Domar

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Reflections on economic development

I have tried to analyze the friendship of my Friday Niters. I trace it back thirty years to the time when I came to Wisconsin and had given up my first ideas of teaching. I began simply to tell my classes personal stories of my mistakes, doubts and explorations, just as they happened to occur to me, injecting my generalizations, comparisons and all kinds of social philosophies. . . .

John R. Commons, *Myself*

If the establishment of the John R. Commons Lecture is a new experiment for Omicron Delta Epsilon, so is its preparation for me.* For these "Reflections" are not a research paper but a discourse. They contain no formulas, mathematical appendixes, statistical tables, and footnotes, the indispensable props of my other efforts. I believe that it behooves an economist between ages of maturity and senility to engage in such a discourse occasionally, and Commons' words give me the courage to try. But they do not remove my fear that this discourse, like many such, will be trivial.

I

In a game of free associations among economists, the expression "economic development" is likely to be followed by "model" and "plan." A plan usually aims at maximizing the rate of growth of consumption or income either by solving an explicit system of equations (and inequalities), or by selecting a preliminary target rate and adjusting it by iteration. In either case, a so-called bill of final goods (or its equivalent) is customarily drawn up and is combined with a matrix of input coefficients to find the required inputs (labor, capital, materials, foreign exchange), and the resulting outputs. Soviet planners prefer to begin with a target list of several important outputs (like steel, fuel, power, etc.), rather than with that of final products, and even though their use of input-output techniques, at least until recent years, has been less explicit and elegant than

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ours, the difference in approach, from the point of view of this lecture, has been slight.

Obviously, a reliable matrix of input coefficients is the heart of this planning process, and clearly the change in the coefficients, that is the saving on the various inputs over time, must constitute an important ingredient of growth. Since I have promised to avoid formulas, let me merely state that the average relative change in the coefficients named by Leontief the "Index of Structural Change," and similar to Solow's "Index of Technical Change," and to Kendrick's "Index of Total Factor Productivity," accounts for a large fraction of the rate of growth of income in advanced countries: some 40 or 50 percent of the total rate of growth, and perhaps some 70-80 percent of the rate of growth of income per capita. We know less about the behavior of such indexes in underdeveloped countries, but it stands to reason that a similar, though possibly less pronounced, phenomenon must exist there as well.

Now the remarkable fact is that the planner usually takes the changes in most input coefficients as given, that is as determined outside of the plan itself. This attitude is a tribute to his common sense: he knows that the planning organization can do little to achieve the proper reductions. The Russians have indeed tried, both by appeal to socialist patriotism and by direct command, to regulate thousands upon thousands of coefficients, which they call "norms" (of which an enterprise may have as many as five hundred). The truth is that Soviet planners (by their own admissions) simply do not know which norms should be reduced in what enterprise and by how much, and are loath to allow any increases, however necessary they may be. Their attempts to regulate norms from above have produced little more than straight jackets for their managers, who try to escape from them by misreporting and cheating. The French have done more explicit planning than other Western countries; but even they, to my knowledge, have not tried to prescribe specific norms to firms.

In contrast, most governments of advanced Western and of socialist countries have been quite successful (depending of course on your standards) in achieving a reasonable degree of macro-equilibrium. The Russians, for instance, have had no serious inflation since their monetary reforms of the late nineteen-forties, and mass unemployment has been unknown in the West for a quarter of a century.

This success in macro-planning, combined with the obvious inability of a government, even as strong and as dedicated to all kinds of planning as the Soviet, to enforce, and even to know, the correct micro-decisions, strongly suggests that at the present state of economic knowledge governments should concentrate their activities in the macro-sphere. And they should promulgate some general rules and incentives to insure that the

correct micro-decisions are made, as they should be made, in a decentralized manner, on the spot, by those who have the necessary detailed information. There is no clear dividing line between macro- and micro-decisions; the existence of externalities, increasing returns, monopolies, large risks, and ignorance reduces the effectiveness of decentralized decisions and calls for government interference, particularly in underdeveloped countries where markets are small (see below) and many investment decisions have important external effects. I cannot suggest any simple general rules for the division of functions; much depends on the historical setting in particular countries and on the *relative* ability, efficiency and honesty of government functionaries. But I do suggest that a government begin its planning activities in the macro-area and move into the micro-area only if and when clearly necessary, with the burden of the proof for each such move being placed on the government.

It is this optimal and ever-shifting division between centralized and decentralized decision-making that is, in my opinion, the central economic problem of today, rather than the question of private versus public ownership of the means of production. It was Oscar Lange who clearly perceived the problem in his classical essay on socialism, and not Karl Marx.

Following Lange, the managers of enterprises, private or public, should be instructed to select the least expensive method of production and to equate marginal cost with price (as a general rule subject to proper qualifications and exceptions). But I do not know of any practical way of enforcing this instruction except by ordering the managers to maximize profits, with prices set by the market under competitive conditions, and by the government or some other body under monopolistic ones. The maximization of profits, though under certain important restrictions, has now become the declared policy of the Soviet government.

I fully realize how abstract my simple suggestions are, and I do not imply that the quest for profits in the real world will indeed result in a Pareto optimum. There is no shortage of studies showing the limitations of this method of resource allocation, particularly in underdeveloped countries. It is only that I do not know of any better method for enforcing economic discipline and preventing wholesale waste. The future may present us with a wider choice.

Economic efficiency is served by the pursuit of profits no better than the acquisition of knowledge is by the pursuit of good grades. Neither method is esteemed by intellectuals. A student can get good grades by choosing easy courses, flattering teachers, and even by cheating on examinations. With a small, highly motivated group of students better stimuli are available, as they are in the economic world. But what are we to do in

the age of mass education and of mass production? Should we prescribe the Soviet-type norms to our students, that is the exact number of hours to be spent (by each student individually or by all?) on each subject, with their study hours policed by a horde of proctors, supervised in their turn by super-proctors? And what is to prevent a student from spending the prescribed number of hours looking into the assigned book and thinking of something else?

In the privacy of our faculty lounges we discount the significance of students' grades, and stress instead their intelligence, imagination, creativity, research ability, and other attributes not necessarily reflected in grades. But if a student with a poor record is to claim these attributes, the burden of the proof must be on him.

Similarly, planning agencies, investment banks, international lenders, and foreign donors will have plenty of opportunity, in the privacy of their well-appointed offices, to re-examine the submitted projects (particularly when externalities are involved or the price system is defective) and rank them not necessarily in order of the expected rate of profit; nor should a manager's performance be judged on that basis alone. But the burden of the justification for an unsatisfactory profit rate, actual or expected, should rest with enterprise managers and project sponsors.

So far I have tried to bypass the question of private as against public ownership of the means of production, or of capitalism versus socialism, and concentrate instead on the making of economic decisions under either system. I have no general solution to this complex question independently of time or place. I wish (though I do not hope) that this question could be discussed with less passion, and that our government would not try to force capitalism on unwilling people, even though my own advice to the underdeveloped countries is to try capitalism first. Their governments are simply not yet ready to undertake the very complex and difficult task of managing their economies. Few governments are. Can you imagine the mismanagement, waste and corruption which would accompany an attempt by the government of my own Commonwealth of Massachusetts to take over its economy? A sharp movement toward socialism in an underdeveloped country invariably antagonizes and frequently destroys the class of capitalist owners and managers who are so scarce there to begin with; their replacement by socialist administrators is a slow and painful process involving much waste. And when all is said and done, it remains true, particularly in underdeveloped countries, that a capitalist owner has a stronger attachment to *his own* resources than a state-appointed official has for the *public* wealth. As President Johnson once remarked, "The best fertilizer for land is the footprint of its owner."

II

I have little hope that my advice to the underdeveloped countries – to experiment with an essentially market-oriented capitalist economy – will be welcome to most of their intellectuals and to many government officials. Since my advice is strikingly unoriginal and is likely to be joined by the majority of American economists, it is worthwhile inquiring into the reasons for its rejection. Let me list several.

1. The market mechanism strives to satisfy effective demand for goods and services which depends on the existing distribution of income and wealth. Granted a lopsided distribution, which is true of many underdeveloped countries, how can one justify the resulting production and importation of luxuries (including sojourns in Miami and on the Riviera) for the few rather than food and shelter for the many? Of course, the distribution of wealth can and should be corrected by taxation, wider access to education, and other measures, but what underdeveloped government is strong enough to attack the holders of wealth? And what is the use of running an efficient economy for a wrong purpose?

2. As a disciplinary device (this being its main function) the profit criterion can be harsh and unfair. It can punish the most well-intentioned and hard-working person and throw riches to the unscrupulous speculator. It is easy to forget this and to join Schumpeter in extolling the selection process supposedly rewarding the able and bankrupting the weakling, but how would we enjoy being on the receiving end? No wonder that the current Soviet reforms oriented toward the market and profits are opposed by many Soviet managers, who would gain freedom but lose security. And who are we to complain, being, as most of the members of this assembly undoubtedly are, either holders of tenure positions or aspirants for them?

3. The next objection is directed not so much against the market economy as such, as against its capitalist incarnation. To put it bluntly, capitalism is an unappetizing system. It runs not on the higher human motivations, but on the lowest – selfishness and greed, which are regularly denounced by the keepers of our conscience on Sundays (and Saturdays), and put to good use the rest of the week. It is hard to love an economic system in which public welfare is merely a by-product of the pursuit of private gain.

Perhaps I am making a virtue out of necessity, but there is a great advantage in propelling an economic system by greed because greed is so abundant. No civilization, to my knowledge, has ever suffered from a shortage. The Russians have tried to run their economic system on much

higher fuels – patriotism and social consciousness – but when they run out of these precious propellants, as they invariably do, they resort to brute force. Lately they have talked more and more about “material self-interest” of the managers and workers in a language reminiscent of the testimony of our business men at congressional tax hearings. But I have to admit that by running our economy on greed we fail to develop moving forces of higher quality, and we suffer from their shortage in our political and social life.

We know that the pursuit by each person of his selfish ends, under proper restrictions and conditions, can result in a reasonably efficient allocation of resources and a good deal of personal freedom, because selfishness need not be forced. On the whole, the practice of *modern* capitalism may be better than its theory (while the opposite may be true of socialism), but it is the theory that attracts intellectuals, and the theory of capitalism is difficult to explain to a person not versed in economics, and particularly to one from an underdeveloped country whose impression of *its* capitalism (symbolized, I imagine, by a picture of peasants devoured by a horde of landowners, money-lenders and tradesmen) is altogether different. In a growing economy like ours where national wealth, roughly speaking, doubles every generation, and where abject poverty is relatively rare, one may be tolerant of other people’s making fortunes. Not so, however, in a country with a long history of stagnation (even if no longer present) where the gain for one implies the loss for another. If, to borrow an historical term, our present economic system may be named “Enlightened Capitalism,” one would not so honor its predecessors, nor the capitalist or semi-capitalist systems found in most underdeveloped countries today.

4. The less enlightened phases of capitalism, through which most Western countries passed in their own time, were long remembered for their exploitation of women and children, miserable wages, high profits, repressive taxes, and other ills, which, however horrible in themselves, were nevertheless conducive to capital accumulation and economic development *and were permitted to exist by the ideology of the time*. Many underdeveloped countries are more backward today than Europe was on the eve of the Industrial Revolution, but the ideology of their intellectuals, largely imported from the advanced countries, has little tolerance for such a process. Impressed as we are with the skills and knowledge which underdeveloped countries can obtain from the advanced ones, we may forget that one such import – medical knowledge – has inflicted upon them a growth of population which Europe has not experienced in all her history. Similarly, many ideological imports, appropriate for our state of economic development, are not at all suited for theirs. Besides, they lack the immunity to ideas which we, from long association with them (and

with TV commercials), have developed. Hence the tendency to carry ideas to the extreme. If we are bored with the profit motive, they are apt to reject it altogether. If the pensions paid under our social security system are modest, in Uruguay (according to the *New York Times*) one can retire with a full income at the age of fifty-five. Marxism, I would venture to suggest, as a protest against the social and economic conditions of the working classes of the nineteenth century, has done the Western countries much more good than harm. (How mild does the Communist Manifesto of 1848 sound to-day!) But when exported to Russia and China it started a conflagration. One cannot embargo ideas, and it is the import of Western ideas into the underdeveloped countries that contributes to the rejection of capitalism.

5. The last reason for this rejection which I would like to offer (there must be many others) is *impatience*. As seen by the intellectuals from the underdeveloped countries, what does this system have to offer? First, the development and export of agricultural and mining products, with all the uncertainties of the world demand for them. Then, a gradual expansion of light industries, beginning with food, textiles, and the like, and the refining of minerals. All through this period they will be threatened with inflation to which a market economy easily succumbs when it tries to move fast, and their dependence on advanced countries for technical help, machinery, spare parts, materials, and foreign exchange in general, will continue and even increase. And finally, after a long period of apprenticeship during which their rich are likely to get richer, and the poor poorer (at least for a while), they will eventually reach our present standard of living from which we, at the time, will be miles away.

Realistically speaking, perhaps there is no faster method. But how unexciting this prospect is! Soviet economic literature of the nineteen-twenties, reflecting this feeling, was obsessed with speed. Capitalist countries must be overtaken not in generations, but in ten-fifteen years. No other promise could have satisfied the Soviet leadership of the time, nor the Chinese leaders of today.

Suppose, while driving to a very important appointment (or a final examination) you suddenly have a flat tire. Twenty minutes later you are ready to go on, but you know how long the trip takes, and you know that you will be terribly late if you follow your usual route. What are you to do? Presently, stopping for a traffic signal, you notice a left turn which you have never taken before. It is in the generally correct direction, but it may lead nowhere and delay you even more. In desperation, you make the turn. You will probably fail. But – who knows – perhaps you will discover a new and faster route and make your appointment after all. You *know* that otherwise you are bound to be late.

According to what I call the "Gerschenkron Law" (which is a bit tautological, but interesting nevertheless), the more backward a country is, the greater are the tensions arising in it and the more radical are its industrialization methods. England got along without any special innovations; France, and particularly Germany, developed the investment banks. The big push in Russia and Japan in the last century came from the government. Russian innovations since 1928 and Chinese since 1949 have been most radical, and yet one wonders what Africa will do in her time. We may disapprove of these costly, even if heroic, methods of development, but we must understand the preference for them by many intellectuals in underdeveloped countries.

III

I suspect that you are becoming impatient with my superficial sketch and want to hear the answer to the basic question – what can we do about all this? My first suggestion is not to get excited. Economic development is a difficult and complex process, hard to deal with, because contrary to some of our favorite models, it is essentially not a capital but a human problem. I cannot prove this, but I can illustrate. Take Colombia and Japan. In 1958 the per capita income of Japan (\$285) was, according to the U.N. sources, a bit below that of Colombia (\$301). By now it is probably twice as high. But Japan must be making better use of its capital, so its capital per person is perhaps only some 50–70 percent higher than that of Colombia. Imagine now that the Colombian capital is suddenly increased to the Japanese per capita level. The standard of living of (at least some) Colombians will rise, and even their balance of payments may improve, but no economic miracles will happen. Now reduce the Colombian capital to its original level, but replace the seventeen million Colombians with seventeen million Japanese. Need I continue?

The human problems in economic development and in our War on Poverty at home are similar: in both cases the victim must acquire the middle-class mentality, so much abused by intellectuals: ambition, willingness to accept discipline, ability to work hard and efficiently, to learn, to save and invest, to exercise foresight, and so on. It is curious that most of these virtues would please both a good New England puritan (if any are still left there) and a good Russian communist. Indeed, the human ideal of the two creeds is strikingly similar, and for good economic reasons, though the puritan would naturally stress one's responsibility to God, and the communist to socialism.

So far this looks not like an economic, but a psychological problem which might best be left to our colleagues on the other floor or in the

other building. But our colleagues have proved singularly ineffective (or much wiser than we are); hence the operationally-minded economist must do what he can do. We cannot increase human happiness directly, but we can increase a person's income and his choice of occupations, improve his health and widen his horizon, in the hope that these changes will make him happier. Similarly, we cannot change the human beings and the society in the underdeveloped countries directly, but we can suggest some reasonably practical measures with helpful direct and indirect effects. Here are a few:

1. Education (including technical assistance). This is the most direct way of transforming both individuals and societies – witness the Soviet and Chinese efforts and recall the striking achievements of the Jesuits in the past. Statistics of the number of souls saved by Christian missionaries in Africa are unfortunately unavailable, but how often one sees the phrase “educated in missionary schools” in the biographies of African leaders. To be sure, education contains risks – dissatisfied intellectuals, Ph.D.'s refusing to return home, barely literate youngsters rejecting manual work, and others – but these risks must be taken. We cannot hope to educate the millions in underdeveloped countries, but we can train teachers, help finance selected areas, set standards of excellence, and hope for the “demonstration effect.” At present, aid to formal education comprises only some two or nine percent (depending on the denominator used) of our foreign aid. Why should it not be magnified ten or twenty times? Surely it will do much more good and much less harm than military aid.

2. Birth control. Hardly any comments are needed here. Perhaps future historians will ridicule our concern with a population of *only* three billions in the presence of empty spaces in much of the Americas, Africa, Australia and Northern Asia, just as we, until recently, ridiculed Malthus. But what matters now is not the opinions of future historians but the growth in the number of mouths to feed, children to educate, and men to be provided with jobs.

3. Economic integration. By area and population many underdeveloped countries look large. For instance, Colombia is larger than France, West Germany, and Italy combined; and it contains 17 million people. But her GNP in 1963 was hardly \$5 billion, about a third of that of the state of Massachusetts, and less than the GNP generated by the Boston Metropolitan Area. International income comparisons are notoriously inexact, and perhaps Colombia's income is understated. But a part of her population is still engaged in subsistence farming and is therefore almost outside of the market. Even with a generous correction, Colombia is small by market size, and there are of course many smaller countries.

For that matter, the GNP of *the whole of South America* was estimated (by the parity method) at some \$45 billion in 1963, much less than the \$67 billion of New York State alone. All of Africa was rated at some \$40 billion with \$11 billion generated by the Union of South Africa. Without the latter, the African GNP was below that of the state of Ohio. But New York and Ohio are parts of a larger economic entity, while neither South America nor Africa comprises one.

We should persuade, push and even bribe the underdeveloped countries into forming free trade areas and common markets. Only then will they benefit from economies of scale and of specialization and will be able to reduce the risks inherent in foreign trade. The argument that their economies are similar to one another and that they therefore trade more with the advanced countries than among themselves makes just as little sense as a similar argument that might have been presented to our Founding Fathers in regards to the thirteen American states.

4. Emergency assistance in case of natural calamities, famines, epidemics and the like. The humanitarian reasons for such aid require no comments.

Beyond these four obvious suggestions, foreign aid policy becomes rather complex. It is certainly most proper for us to help the less developed countries to accelerate their development (particularly if we recognize that we are partly responsible for their predicament), and it is in our own interest to do so. The problem is how to help these societies to change themselves rather than to hinder the change, since it is difficult to aid a country without adding strength to its ruling classes and to its government, however unenlightened both may be. It may also not be easy to avoid the creation of the patron-client relationship between the donor and the recipient, which is most unhealthy for both sides. It is very tempting to force reforms on the recipient by the promise of aid. But such reforms can remain on paper, and our insistence that they be carried out according to the agreement made is apt to cause mutual animosity. Besides, seldom is our knowledge about the country sufficient to assure us of the correctness of our stand.

If I have run out of simple positive suggestions, let me make a negative one: that military aid be given only under exceptional circumstances. The sight of Indians and Pakistanis fighting each other with American and British tanks is a good example of the harm that our good intentions can cause. And let us not forget that Trujillo rose to power in the Dominican Republic on the shoulders of American-trained constabulary. In our obsession with fighting communism we tend to over-emphasize the effectiveness of military means; we seem to have forgotten Lenin's dictum that it is not the rifle that fires but the man who pulls the trigger.

IV

Above all, let me repeat, we should not get excited every time a riot, a coup, a revolution or a counter-revolution sweeps some underdeveloped country. Economic change without political change is impossible, and the latter does have a nasty habit of not always proceeding in a nice, evolutionary and democratic manner. What the present-day advanced countries have accomplished over generations, the underdeveloped ones must do in a few decades, and usually with weak and inefficient governments. If France has gone through five republics, four major revolutions and several near-revolutions in less than two hundred years, surely each underdeveloped country is entitled to its quota of political upheavals concentrated into a short span of time.

During this process many underdeveloped countries will enjoy spells of democratic rule interspersed with military, rightist, leftist, tyrannical, benevolent, and all sorts of dictatorships. It is altogether possible that *in the middle* of their developmental process some will go communist. I would venture to suggest that communism is an experience (some would say a disease) of adolescence. No advanced country has yet succumbed to it (except by foreign force, like East Germany and Czechoslovakia), while Russia and other East European countries are beginning to recover from it as their economies develop. The Chinese are not entirely wrong in questioning the purity of the present-day Russian communism, and perhaps the Africans will question the Chinese variety some day. It was comfortable to think that communists could seize power only after a long and exhausting war (Russia, China, Yugoslavia), or under foreign pressure (the rest of Eastern Europe). Cuba has destroyed this pleasant belief, and the state of Kerala in India has shown that communists can win even a reasonably fair election. Some day they may repeat this feat in a whole country, and it will be particularly galling to us if that country has grown to adolescence with our aid, and if the communist leaders were trained in American-organized or aided schools.

I do not wish communism on any country, advanced or underdeveloped, but we must realize that the chances for our *effective* interference are small. If we only knew how to save a country during those critical years some action might be recommended. But our performance in Russia and China in the past, and in Viet Nam and in the Dominican Republic at present has revealed a striking degree of ignorance and ineptitude. Indeed, it is likely that in our anxiety to permit only an orderly change we may inhibit any change, and thus create the most favorable conditions for a communist victory. The recent House resolution authorizing our intervention in Latin American countries to save them from communism

which was, by the way, opposed by the would-be victims of our benevolence – the irony of it! – is a rare example of political stupidity, to put it mildly. At best it will be ineffective; at worst, it will give the respective regimes a false sense of security and lead them into traps from which we will be unable to rescue them when the time comes.

For her role in defeating Napoleon, Russia enjoyed a brief spell of good will from other European countries. But Russian opposition to every popular movement which threatened the existing order in Europe eventually made her the most hated country on that continent. We also enjoyed a period not only of international good will but of real affection at the close of World War II. Need I belabor my parallel?